Some In Congress Want US to Follow France Down Transaction Tax Path

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France on Wednesday imposed a 0.2 percent transaction tax on certain stock purchases. Leaders in Germany, Italy and Spain are also pushing for a similar tax.

The move to implement taxes on financial transactions hasn't gone unnoticed in the United States. Senator Tom Harkin (D-Iowa) and Representative Peter DeFazio (D-Oregon) in November 2011 introduced to their respective chambers of Congress the "Wall Street Trading and Speculators Act," which calls for a 0.03 percent tax on trading transactions.

'Big Enough to Wipe Out Transactions'

While a tax at this rate has been described as tiny, it is far from it. According to a new Cato Institute study, a tax of 0.02 percent would be "big enough to wipe out all S&P 500 index futures transactions."

The study faults the models used by the Congressional Budget Office to score the bill for underestimating the effects on trading volume and overestimating potential tax revenues. The study noted the CBO models assume there are no suitable international substitutes for financial contracts traded in the United States. Anyone who is familiar with today's trading platforms knows that trading on an exchange elsewhere in the world is only a mouse click away, and the range of products offered on exchanges outside of the United States has grown dramatically in recent years.

Another aspect of the Harkin-DeFazio bill is that it is not solely a method to raise tax revenue. The bill aims to reduce short-term speculative trading that the proponents believe causes unnecessary market volatility. The proposed tax would, in some instances, lead to a 6,000 percent increase in transaction costs for exchange members. Transaction costs are already their biggest expense.

Benefits of Short-Term Trades

Some advocates of short-term speculative trading warn a tax could actually increase market volatility by reducing trading and making capital markets less efficient. This would happen if markets that are dominated by arbitrageurs become too expensive for arbitrage trading. Arbitrage trading links together related markets on a worldwide basis. This linking of markets -- for instance, US Treasury Bonds to German Bunds and Japanese Bonds -- adds significant depth and liquidity to the marketplace as it effectively creates one large market as opposed to smaller stand-alone markets.

As one example, if large sell orders are depressing prices in US Treasuries to where Treasuries are becoming out of line with other markets, arbitrage traders would purchase Treasuries while simultaneously selling German Bunds or other related instruments. This would take the downward price pressure off of the Treasury market. If arbitrage trading were curtailed due to a tax, then this vital linking of markets would be lost.

A tax that targets short-term trading is similar to a chemo-therapy treatment for cancer. It kills all fast-growing cells indiscriminately whether they are harmful or not. The level of dosage for the market that has been proposed in the form of a tax is most likely high enough to kill the patient – even when there is doubt whether the patient has "cancer."

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